No. 94-1119

Supreme Court, U.S.
FILED
JAN 25 1995
OFFICE OF THE CLERK

IN THE
Supreme Court of the United States
OCTOBER TERM, 1994

20TH CENTURY INSURANCE CO., *et al.*,
Petitioners,

v.

CHARLES QUACKENBUSH,
INSURANCE COMMISSIONER, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the Supreme Court of California

---

REPLY BRIEF FOR PETITIONERS

WILLIAM A. MONTGOMERY
JUDITH K. MINTEL
STATE FARM INSURANCE COMPANIES
One State Farm Plaza
Bloomington, IL 61710
(309) 766-3520

PAUL ALEXANDER
VANESSA WELLS
HELLER, EHRMAN, WHITE & MCAULIFFE
525 University Avenue
Suite 1100
Palo Alto, CA 94301
(415) 326-7600

Counsel for State Farm Mutual Automobile Insurance Company, State Farm Fire and Casualty Company, and State Farm General Insurance Company

JOHN G. ROBERTS, JR.*
DAVID G. LEITCH
AUDREY J. ANDERSON
HOGAN & HARTSON L.L.P.
555 Thirteenth Street, N.W.
Washington, D.C. 20004
(202) 637-5810

Counsel for Petitioners

GARY L. FONTANA
WYNNE S. CARVILL
THELEN, MARRIN, JOHNSON & BRIDGES
Two Embarcadero Center
Suite 2200
San Francisco, CA 94111
(415) 392-6320

JOHN R. BOLLINGTON
20TH CENTURY INSURANCE COMPANY and 21ST CENTURY CASUALTY COMPANY
6301 Owensmouth Avenue
Suite 700
Woodland Hills, CA 91367
(818) 704-3700

Counsel for 20th Century Insurance Company and 21st Century Casualty Company

* Counsel of Record

WILSON - EPES PRINTING CO., INC. - 789-0096 - WASHINGTON, D.C. 20001

11pp

TABLE OF AUTHORITIES

Cases Page

Appeal of Cheshire Bridge Corp., 126 N.H. 425, 493 A.2d 1151 (1985) 6
Appeal of Public Serv. Co. of New Hampshire, 130 N.H. 748, 547 A.2d 269 (1988) 4, 5, 7
AT&T v. *FCC*, 836 F.2d 1386 (D.C. Cir. 1988) 6
Attorney General v. *Department of Pub. Utils.*, 392 Mass. 262, 467 N.E.2d 72 (1984) 6
Central Maine Power Co. v. *Public Utils. Comm'n*, 153 Me. 228, 136 A.2d 726 (1957) 7
Duquesne Light Co. v. *Barasch*, 488 U.S. 299 (1989) 8
Federal Power Comm'n v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944) ..... *passim*
Guaranty Nat'l Ins. Co. v. *Gates*, 916 F.2d 508 (9th Cir. 1990) 1, 3
Hastings v. *Village of Stowe*, 125 Vt. 227, 214 A.2d 56 (1965) 7
Jersey Central Power & Light Co. v. *FERC*, 810 F.2d 1168 (D.C. Cir. 1987) (en banc) 2, 3
New England Tel. & Tel. Co. v. *Department of Pub. Utils.*, 327 Mass. 81, 97 N.E.2d 509 (1951) .. 7
Tennessee Gas Pipeline Co. v. *FERC*, 926 F.2d 1206 (D.C. Cir. 1991) 6
United States v. *FCC*, 707 F.2d 610 (D.C. Cir. 1983) 6, 7

Other

A. Lawrence Kolbe & William B. Tye, *The* Duquesne *Opinion: How Much* "Hope" *Is There For Investors in Regulated Firms?*, 8 Yale J. on Reg. 113 (1990) 4-5
Stephen F. Williams, *Fixing the Rate of Return After* Duquesne, 8 Yale J. on Reg. 159 (1990) 4-5

IN THE

Supreme Court of the United States

OCTOBER TERM, 1994

No. 94-1119

20TH CENTURY INSURANCE CO., *et al.*,
Petitioners,

v.

CHARLES QUACKENBUSH,
INSURANCE COMMISSIONER, *et al.*,
Respondents.

On Petition for a Writ of Certiorari to the Supreme Court of California

---

REPLY BRIEF FOR PETITIONERS

The Insurance Commissioner's brief in opposition to certiorari confirms the need for this Court to grant review.[1] That filing is remarkable in its failure even to attempt to defend the constitutional analysis in the opinion below.

1. The California Supreme Court ruled that it was an error to assume that "a regulated firm is entitled to its cost of capital," App. 116a, rejected the Ninth Circuit's holding in *Guaranty Nat'l Ins. Co.* v. *Gates*, 916 F.2d 508 (1990), that a constitutional rate of return "must

[1] Charles Quackenbush assumed office as Insurance Commissioner on January 2, 1995, and is substituted for his predecessor John Garamendi pursuant to S. Ct. Rule 35.3. Petitioners' Rule 29.1 statement appears at Pet. ii.

necessarily be above the 'break even' level," App. 79a n.18, and instead upheld an order requiring 20th Century to pay back 78 million dollars because the court believed 20th Century could do so without incurring "deep financial hardship." *Id.* at 115a.

We restate the California Supreme Court's decision because the Insurance Commissioner evidently has no desire to defend it on its own terms. Disavowing the court's rationale and holding, the Commissioner instead argues that the court held "that insurers are constitutionally entitled to a reasonable profit," and criticizes us for "imput[ing] to that court the opinion that there is no constitutional right to a profit at all. That is not what the court held." Opp. at 2, 3. Here is what the court stated in its opinion, not once but twice: 20th Century " 'has no constitutional right to a profit * * *.' Indeed, it has no constitutional right even against a loss." App. 79a, 123a (quoting *Jersey Central Power & Light Co.* v. *FERC*, 810 F.2d 1168, 1180-81 (D.C. Cir. 1987) (en banc)). That is also precisely what the Commissioner has argued throughout this litigation. *See, e.g.*, App. 209a (Superior Court rejecting Commissioner's argument that only a rate which "deprives me of the ability to cover my out-of-pocket costs" can be confiscatory); Commissioner's Reply Br. before Cal. Supreme Ct., at 40 (arguing that there is no confiscation unless rates "precluded the producer from recovering its out-of-pocket costs"). The Commissioner's effort now to distance himself from the actual ruling below—the ruling he sought—amply confirms the need for this Court to review that ruling.[2]

---

[2] Other regulatory officials are taking the California Supreme Court at its word. The Texas Office of Public Insurance Counsel, for example, recently relied upon the opinion below for the proposition that "a 0% operating profit is not confiscatory." Reply Brief at 4, Private Passenger and Commercial Automobile Insurance Rates Concerning the Texas Automobile Insurance Plan Association, Docket No. 454-94-1055.G. Indeed, the Commissioner in places also acknowledges the ruling below. After quoting *Federal Power*

2. The Commissioner in effect advises this Court not to trouble itself over the legal standard adopted by the California Supreme Court, because 20th Century received a ten percent return under the formula, which must as a matter of law be constitutionally adequate. *See* Opp. at i. The Commissioner, however, relies for his version of the facts on the views of his own administrative law judge, without acknowledging that the trial court rejected those views in factual findings undisturbed by the California Supreme Court. The trial court expressly found that 20th Century did *not* receive the ten percent return the Commissioner himself determined was the constitutional minimum, App. 177a n.20, 184a & n.30, that there was "substantial evidence that [a] 10% rate of return is inadequate as to 20th Century and that 20th Century's lower boundary reasonable rate of return was at least 20%," *id.* at 202a, and that "[t]here is no evidence * * * contradicting 20th Century's evidence, and thus no basis for rejecting it." *Id.*

The California Supreme Court rejected 20th Century's confiscation claim not because it disagreed with the trial court's view of the evidence, but because—like the administrative law judge—it found that evidence "imma-

---

Comm'n v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944), to the effect that the rate of return "should be sufficient to assure confidence in the financial integrity of the enterprise," the Commissioner argues that "[f]inancial *integrity* sounds in solvency, not in degree of profitability," Opp. at 10 (emphasis in original)—reiterating his contention that a return that avoids insolvency satisfies the *Hope* standard. *See also* Opp. at 21 n.15 (assertion that cases "uphold[] rate orders that protect only out-of-pocket expenses—that leave *no profit* at all") (emphasis in original). *Contrast Guaranty Nat'l Ins. Co.* v. *Gates*, 916 F.2d at 515 (striking down rates that "guarantee only that an insurer will break even" because they "do[] not guarantee the constitutionally required 'fair and reasonable return'"); *Jersey Central*, 810 F.2d at 1175 (test that would allow court to set aside rates "only if [they] would put the utility in bankruptcy" rejected as "dramatically at odds with the law").

terial." App. 30a. The Commissioner concedes as much. Opp. at 24 n.17. The California Supreme Court found no confiscation because 20th Century failed to show "deep financial hardship," not because it received an adequate return given the cost of capital. Our Petition does not ask this Court to decide what return 20th Century received, or to calculate 20th Century's cost of capital. All we seek is a hearing on our confiscation claim under the correct constitutional standard. The only court in this case to have applied that standard—the *Hope* standard—found that the rates permitted 20th Century were confiscatory. App. 202a. Given that record, the Commissioner cannot avoid certiorari by arguing that it makes no difference which legal standard is applied.

3. We explained in the Petition that there is a sharp conflict among the lower courts on the question presented, with most courts agreeing with Justice Souter's statement that "a utility's threshold entitlement is to a rate of return equal to the cost of capital," *Appeal of Public Serv. Co. of New Hampshire*, 130 N.H. 748, 547 A.2d 269, 270-271 (1988). while a minority agree with the court below that a regulated firm "has no right" to "its cost of capital." App. 116a. *See* Pet. at 19-28 (surveying cases). The Insurance Commissioner seeks to obfuscate this plain conflict by adopting an unduly narrow definition of "cost of capital"—one not shared by this Court, the court below. or any of the courts whose decisions conflict with the decision below. According to the Commissioner, "cost of capital" means only *actual* current obligations to existing holders of a company's securities. Opp. at 9.

The "classic definition of the cost of capital," however, is—according to Judge Stephen Williams—the " 'expected rate of return * * * on alternative investments of equivalent risk.' " [3] This is the definition adopted by the

---

[3] Stephen F. Williams, *Fixing the Rate of Return After* Duquesne, 8 Yale J. on Reg. 159, 160 (1990) (ellipses in original) (quoting

court below, which stated that " '[c]ost of capital' may be defined as the rate of return available in the marketplace on investments comparable in terms of risk and otherwise * * *." App. 30a. It is the definition employed by this Court, which has recognized at least since *Hope* that the return to investors should afford "enough revenue * * * for the capital costs of the business," and that "[b]y that standard the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks." 320 U.S. at 603. And it is the definition employed by the various courts whose decisions conflict with that of the court below. *See, e.g., Appeal of Public Serv. Co. of New Hampshire,* 547 A.2d at 274 (citing *Hope* as holding that "risks undertaken by a regulated utility should be compensated by returns commensurate with similar risks in other businesses").

Thus, the Commissioner is simply wrong in contending that "the decision below is consistent with prior cases in recognizing the regulated firm's entitlement to its 'capital costs,' by which the cases refer to the actual payment of interest obligations and dividends." Opp. at 9.[4] The court below rather plainly did not use "cost of capital" to refer to "the actual payment of interest obligations and dividends;" on the contrary, as noted, it expressly defined the term as referring to "the rate of return available in the marketplace on investments comparable in terms of risk and otherwise." App. 30a. And the court equally plainly

---

A. Lawrence Kolbe & William B. Tye, *The* Duquesne *Opinion: How Much* "Hope" *Is There For Investors in Regulated Firms?,* 8 Yale J. on Reg. 113, 138 (1990)). *See* Pet. at 11 n.6.

[4] The Commissioner's effort to distinguish the Ninth Circuit's decision in *Gates* on this basis is unavailing. *See* Opp. at 15-16. Several of the insurers in *Gates* were non-stock companies with, under the Commissioner's definition, *no* cost of capital, because they had no current payment obligations to any holders of the companies' securities. If the Ninth Circuit shared the Commissioner's view, the Nevada rollback statute should not have been held unconstitutional with respect to those insurers.

did *not* recognize a firm's entitlement to its cost of capital; on the contrary, the court below expressly ruled that the Superior Court erred in its "assumption * * * that a regulated firm is entitled to its cost of capital." *Id.* at 116a.[5]

The Commissioner attempts to gloss over the conflict among the lower courts documented in the Petition by stating that the cases we cite "simply parrot *Hope*'s general description of the investors' interest in covering [capital costs]." Opp. at 15 n.12. This will not do. What the cases *hold* is that the rate of return "must" cover the cost of capital,[6] that investors are "entitled" to a return

---

[5] The Commissioner's definition leads to the absurd result that a regulated entity that does not actually resort to the capital markets (*e.g.*, because it has no debt and is privately held) is entitled to a zero rate of return, because it has no "actual payment of interest obligations and dividends." Opp. at 9.

The cost of capital is also often defined as the rate of return necessary to "attract capital" to the regulated enterprise. *See Hope*, 320 U.S. at 603. This definition is indistinguishable from one that looks to the rate of return on investments of comparable risk. *See id.* The lowest return necessary to attract capital equals the return available on investments of comparable risk, because if it were any lower capital would seek the higher return on the other investments with a comparable degree of risk.

[6] *E.g.*, *Tennessee Gas Pipeline Co.* v. *FERC*, 926 F.2d 1206, 1208 (D.C. Cir. 1991) ("utility investors must be allowed an opportunity to earn returns sufficient to 'attract capital' * * * and 'to compensate [the] investors for the risks assumed' ") (quoting *Hope*, 320 U.S. at 605); *AT&T* v. *FCC*, 836 F.2d 1386, 1389-90 (D.C. Cir. 1988) ("The rate return * * * must be sufficient to cover the cost of capital the carrier must raise to do business"); *United States* v. *FCC*, 707 F.2d 610, 612 (D.C. Cir. 1983) ("The return to the equity owner must be 'sufficient to assure confidence in the financial integrity of the enterprise * * * in order that its credit may be maintained and capital may continue to be attracted.' ") (quoting *Hope*, 320 U.S. at 603); *Appeal of Cheshire Bridge Corp.*, 126 N.H. 425, 493 A.2d 1151, 1156 (1985) ("At a minimum, the return must equal the cost of capital"); *Attorney General* v. *Department of Pub. Utils.*, 392 Mass. 262, 467 N.E.2d 72, 75 (1984) ("In general, the return on equity must equal at least the amount which the

sufficient to cover the cost of capital,[7] and that investors have a "constitutional right" to such a rate of return.[8] This language simply cannot be reconciled with the assertion by the court below—repeated over and over again —that recovery of the cost of capital is "an interest that the producer may pursue and not a right that it can demand." App. 79a; *see id.* at 85a-86a, 116a, 123a. Only this Court can resolve this conflict over the meaning of its decision in *Hope*. It should grant certiorari to do so.[9]

4. Not content to rewrite the California Supreme Court opinion, the Insurance Commissioner attempts to rewrite our Petition as well. We most emphatically do not maintain, as the Commissioner would have it, that

---

company would have to pay in order to 'hire' its equity capital under current conditions") (citation omitted); *Hastings* v. *Village of Stowe*, 125 Vt. 227, 214 A.2d 56, 61 (1965) ("the rate of return must be sufficient to provide enough revenue for capital costs of the business, including service on the debt and dividends on the stock").

[7] *E.g.*, *United States* v. *FCC*, 707 F.2d at 612 ("Regulated utilities are entitled to earn enough revenue not only to cover operating expenses but also to pay for the capital costs of doing business"); *Appeal of Public Serv. Co. of New Hampshire*, 547 A.2d at 270-271 ("a utility's threshold entitlement is to a rate of return equal to the cost of capital").

[8] *E.g.*, *Central Maine Power Co.* v. *Public Utils. Comm'n*, 153 Me. 228, 136 A.2d 726, 740 (1957) ("one of the constitutional rights of a regulated utility is the right to earn a sufficient return to maintain its credit and to obtain additional capital when needed to enable it to serve its public") (quoting *New England Tel. & Tel. Co.* v. *Department of Pub. Utils.*, 327 Mass. 81, 97 N.E.2d 509, 516 (1951)).

[9] Although the Commissioner now asserts that there is no conflict or confusion among the lower courts, he was more candid before the California Supreme Court, acknowledging that "it is not clear what showing is required to establish confiscation." Comm'r Opening Br. at 60. The Superior Court cited an analysis of the conflict among the lower courts in concluding, in the course of granting a stay, that "there is reasonable likelihood that certiorari will be granted." App. 373a.

"regulation may not reduce the value of a regulated firm." Opp. at 17, 19. Our Petition made that clear: "there can be no constitutional objection simply because 'the value of regulated property is reduced as a consequence of regulation.'" Pet. at 28 (citation omitted).

At the same time, this Court has reaffirmed that if authorized rates do not afford a regulated firm "sufficient compensation," then the State has "violated the Fifth and Fourteenth Amendments." *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299, 308 (1989). In *Hope*, this Court set the measure of "sufficient compensation" by ruling that "the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks." 320 U.S. at 603. *See Duquesne*, 488 U.S. at 312. That standard—the cost of capital—does not, as the Commissioner suggests, insulate regulated firms from any reduction in value. It does, however, "assure confidence in the financial integrity of the enterprise, so as to maintain its credit and to attract capital." *Hope*, 320 U.S. at 603. The conflicting standard embraced by the court below—"deep financial hardship," *see* App. 26a, 33a, 70a, 81a, 81a-82a, 83a, 85a, 115a, 121a, 122a—plainly does not assure confidence in financial integrity, maintain credit, or attract capital, as required by *Hope*.

5. The Commissioner does not and cannot dispute that the question presented is important and recurring, or that the case is a "test case" that will govern the disposition of hundreds of other pending cases. *See* Pet. at 28; App. 3a, 34a & n.6, 373a. Nor does the Commissioner respond at all to our showing that the ruling below has profound extraterritorial impacts, impacts that only a ruling from this Court can redress.[10] This Court should grant cer-

---

[10] *See* Pet. at 28-29; *see also* Brief of Respondent United Services Automobile Association, at 5-6 (ruling below presents multistate insurers with a "Hobson's choice between breaking relationships with policyholders while they are in California or weakening the security of all other policyholders by continuing to operate in

tiorari to resolve the conflict among the lower courts and to restore a uniform understanding of the federal constitutional limits on rate regulation.

CONCLUSION

For the foregoing reasons, and those in the Petition, this Court should grant the writ and reverse the decision below.

Respectfully submitted,

WILLIAM A. MONTGOMERY
JUDITH K. MINTEL
STATE FARM INSURANCE COMPANIES
One State Farm Plaza
Bloomington, IL 61710
(309) 766-3520

PAUL ALEXANDER
VANESSA WELLS
HELLER, EHRMAN, WHITE & MCAULIFFE
525 University Avenue
Suite 1100
Palo Alto, CA 94301
(415) 326-7600
Counsel for State Farm Mutual Automobile Insurance Company, State Farm Fire and Casualty Company, and State Farm General Insurance Company

JOHN G. ROBERTS, JR.*
DAVID G. LEITCH
AUDREY J. ANDERSON
HOGAN & HARTSON L.L.P.
555 Thirteenth Street, N.W.
Washington, D.C. 20004
(202) 637-5810
Counsel for Petitioners

GARY L. FONTANA
WYNNE S. CARVILL
THELEN, MARRIN, JOHNSON & BRIDGES
Two Embarcadero Center
Suite 2200
San Francisco, CA 94111
(415) 392-6320

JOHN R. BOLLINGTON
20TH CENTURY INSURANCE COMPANY and 21ST CENTURY CASUALTY COMPANY
6301 Owensmouth Avenue
Suite 700
Woodland Hills, CA 91367
(818) 704-3700
Counsel for 20th Century Insurance Company and 21st Century Casualty Company

* Counsel of Record

California"); Brief of Respondent Preferred Risk Mutual Insurance Company in Support of the Petitions, at 6 (ruling below "will result in insurance consumers in other States subsidizing insurance consumers in California").